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No. 86-1006

IN THE
Supreme Court of the United States
OCTOBER TERM, 1986

MARATHON OIL COMPANY,
an Ohio corporation,
Petitioner,
v.

UNITED STATES OF AMERICA, UNITED STATES DEPARTMENT OF THE INTERIOR; DONALD HODEL, Secretary of the Interior; ESTHER WUNNICKE, Commissioner of the Department of Natural Resources, State of Alaska; COOK INLET REGION, INC., an Alaska corporation,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE AND BRIEF AMICUS CURIAE OF THE AMERICAN PETROLEUM INSTITUTE

Of Counsel
THOMAS L. CUBBAGE II
1256 Adams Building
Bartlesville, OK 74004

G. WILLIAM FRICK
(Counsel of Record)
DAVID T. DEAL
PHILIP A. COONEY
AMERICAN PETROLEUM INSTITUTE
1220 L Street, N.W.
Washington, D.C. 20005
(202) 682-8246
Counsel for Amicus Curiae

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

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MOTION OF AMERICAN PETROLEUM INSTITUTE FOR PERMISSION TO FILE BRIEF AMICUS CURIAE

Amicus Curiae American Petroleum Institute (API) respectfully moves the Court to grant it leave to file a brief in support of the Petition for a Writ of Certiorari in the captioned matter. API moves for such leave on the following grounds:

1. All parties to this litigation have consented to API's participation as *amicus curiae*, with the exception of Respondent Cook Inlet Region, Inc. (CIRI).

2. On December 31, 1986, API requested the consent of all parties, including CIRI. It was not until February 19, 1987 that counsel for CIRI, by telephone, denied this request. Such denial followed API's receipt of the consent of Petitioner Marathon and Respondents, the United States of America and the State of Alaska.

3. CIRI consented, along with the other parties, to API's participation in the United States Court of Appeals for the Ninth Circuit as *amicus curiae.*

4. API is a national trade association whose over 200 company members represent all facets of the petroleum industry: exploration, production, transportation, refining, and marketing. Many of API's members are actively engaged in the acquisition and development of federal oil and gas leases and are, therefore, directly affected by policies for valuation of natural gas production for royalty purposes. In this regard, API's member companies have a significant interest in the outcome of this litigation. API has already participated as *amicus curiae* in the proceedings below in the United States Court of Appeals for the Ninth Circuit. Moreover, API has participated in other litigation before this Court involving the calculation of royalties on oil and gas leases. *See, e.g., Ashland Oil, Inc. v. Good,* Nos. 83-1234, 83-1248 and 83-1278; *Kewanee Oil Co. v. Holmes,* No. 83-1250.

WHEREFORE, *amicus curiae API* respectfully moves the Court to grant API leave to file its brief in Support of the Petition for a Writ of Certiorari.

Respectfully submitted,

G. WLLIAM FRICK
(Counsel of Record)
Attorney for American Petroleum Institute

February 23, 1987

QUESTION PRESENTED

Whether the Department of the Interior, through application of the netback method for product valuation, has unlawfully expanded the commercially understood meaning of the statutory terms "production" and "royalty", thereby apportioning to itself a share of downstream entrepreneurial value in its royalty assessment?

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BRIEF AMICUS CURIAE OF THE AMERICAN PETROLEUM INSTITUTE

INTEREST OF THE AMICUS CURIAE

The American Petroleum Institute ("API") submits this brief as *amicus curiae* in support of the petition for writ of certiorari in No. 86-1006. The petition seeks review of a judgment of the United States Court of Appeals for the Ninth Circuit. *Marathon Oil Company*

v. United States, 807 F.2d 759 (9th Cir. 1986). That court affirmed the district court, which had upheld the Department of the Interior's (DOI) application of the netback method to value natural gas for federal royalty purposes. *Marathon Oil Co. v. United States*, 604 F. Supp. 1375 (D. Alaska 1985).

API's position is that this valuation method yields a royalty far in excess of that to which the federal government is entitled under the Minerals Lands Leasing Act. In addition, the netback method as applied in this case raises producers' costs of production, contrary to the policies embodied in federal leasing statutes and other laws. Plenary review by this Court is especially timely in that it would properly define the legal bounds of DOI's authority to collect royalties, a central issue in its pending overhaul of the product valuation regulations.

API is a national trade association whose over 200 company members represent all facets of the petroleum industry: exploration, production, transportation, refining, and marketing. Many of API's members are actively engaged in the acquisition and development of federal oil and gas leases and are, therefore, directly affected by policies for valuation of natural gas production for royalty purposes.

API routinely participates on industry's behalf in legislative, administrative, and judicial proceedings where issues of national significance are presented. This case presents such an issue. Through application of the netback method for product valuation, DOI has expanded the commercially understood meaning of the statutory terms "production" and "royalty", thereby apportioning to itself a share of downstream entrepreneurial value in its royalty assessment. DOI's use of netback valuation methodology has produced an unfair and unlawful result for petitioner Marathon and has significant implications for other producers of natural gas and crude oil who hold federal leases.

REASONS FOR GRANTING THE WRIT

I. The Decision Below Poses Statutory Construction Issues of Fundamental Significance Regarding Future Federal Royalty Management Decisions

The Government's position relies on an unlawful construction of the terms "royalty" and "production" which goes to the heart of every royalty decision. Both the immediate enforcement of this flawed construction and the prospect of setting erroneous legal precedent involve alteration of the financial terms agreed to by the federal government and federal oil and gas lessees. Even the most subtle alteration in the terms underlying this business relationship would necessarily affect the disbursement of an enormous sum of money. In 1985 alone, the most recent year for which such data is available, federal oil and gas lessees paid to the Federal Government $4.54 billion in royalties.[1]

Federal lessees make a multitude of finely calculated decisions based on the anticipated returns from entering the federal leasing relationship. DOI's unlawful imposition of the netback method for product valuation retroactively alters the business terms of the leasing relationship to the government's advantage, with the unfortunate effect of introducing elements of unpredictability and reduced incentive in the federal leasing relationship.

The authority of the Secretary of the Interior to lease onshore federal lands is set forth in the Mineral Lands Leasing Act. 30 U.S.C. §§ 181 et seq. (1982). The Act reserves to the federal government a "royalty of 12½ per centum in *amount or value of the production removed or sold from the lease.*" (emphasis supplied). 30

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[1] Mineral Revenues: The 1985 Report on Receipts From Federal and Indian Leases, United States Department of Interior, Minerals Management Service, Royalty Management Program, Table 2. In 1984, federal oil and gas lessees paid royalties of $4.91 billion.

U.S.C. § 226(c) (1982).[2] In this case, DOI has given lip service at best to the lawful meaning of the terms "royalty" and "production"; however, in applying the netback method, DOI has relied on a far broader and, therefore, unlawful interpretation of those terms. In *Board of Governors v. Dimension Financial Corp.*, —— U.S. ——, 106 S. Ct. 681 (1986), this Court invalidated the interpretation of a statutory term by a federal agency because "[n]othing in the statutory language or the legislative history . . . indicate[d] that the term . . . meant anything different from its accepted ordinary commercial usage." *Id.* at 689.

Whether the Secretary elects to take royalty in "amount" or "value", the "production" to which both refer is necessarily at the lease. Although the term "production" is not expressly defined by the Mineral Lands Leasing Act, its established commercial meaning in state and federal oil and gas law confirms that it refers exclusively to withdrawn substances at the leasehold.[3] It

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[2] Marathon's lease is a so-called "noncompetitive lease." For leases acquired by competitive bidding, the Act's royalty provision is very similar: royalty shall be "not less than 12½ per centum in amount or value of the production removed or sold from the lease." 30 U.S.C. § 226(b) (1982).

The Outer Continental Shelf Lands Act, 43 U.S.C. § 1331 et seq. (1982) confers DOI's offshore leasing authority and similarly requires a royalty equal to a specified percentage "in amount or value of the production saved, removed, or sold from the lease." 43 U.S.C. § 1337.

[3] "Production" is a well-understood commercial term in the oil and gas industry. See Northern Natural Gas Company v. State Corp. Commission of Kansas, 372 U.S. 84, 90 (1963) (the term "production" is narrowly confined to the physical acts of drawing gas from the earth and preparing it for first stages of distribution); Federal Power Commission v. Panhandle Eastern Pipe Line Company, 337 U.S. 498, 518 (1949) (clear and natural meaning of production is the act of bringing forth gas from earth and preparing it for first stages of distribution); United States v. General Petroleum Corp., 73 F. Supp. 225, 254 (S.D. Cal. 1946), (stating

follows that royalty is due only on the value of actual production at the wellhead.

Similarly, commentators have never questioned the fact that a "royalty" is only a passive right to receive a portion of the production from a lease, either in kind or in value.[4] A "royalty" does not include a share in any downstream enhancement of value.[5] As Professor Williams

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that "Natural gas royalties are payable on gas as it is produced at the well. It is the value of gas that must be determined.") *aff'd sub nom.*, Continental Oil Company v. United States, 184 F.2d 802 (9th Cir. 1950); Mesa Petroleum Co. v. U.S, Department of Interior, 647 F. Supp. 1350 (W.D. La. 1986) ("[T]he United States is entitled to royalties as the minerals within the leased area are depleted."); Solicitor's Opinion M-36888 issued October 4, 1976, 84 I.D. 171 (1977) ("production," as used in all federal oil and gas leases includes oil and gas withdrawn from a reservoir). Union Oil Co. of California v. Touchet, 86 So.2d 50, 53 (La. Sup. 1956) (Royalty is a right to share in production of gas, if and when it is produced from the property subject to the royalty); Monsanto Co. v. Tyrell, 537 S.W.2d 135 (Tex.Civ.App. 1976, *writ ref'd. n.r.e.*) (Under Texas law, "production" means the actual physical extraction of the mineral from the soil.)

[4] *See, e.g.*, R. Hemingway, *The Law of Oil and Gas* § 2.5, at 52 (2d ed. 1983); Sneed, *Value of Lessor's Share of Production Where Gas Only Is Produced*, 25 Tex. L. Rev. 641, 648, 650 (1947).

[5] *See* Kretni Development Co. v. Consolidated Oil Corp., 74 F.2d 497 (10th Cir. 1934) (the United States as lessor is not entitled to a share of the profits [or proceeds of sales] delivered from products extracted from gas after it is delivered into a pipeline at the sales point; a lessor's rights are measured and cease at the sales point). *See also* Piney Woods Country Life School v. Shell Oil Co., 726 F.2d 225, 231 (5th Cir. 1984) (the royalty compensates the lessor for the value at the well before the lessee adds value to the gas by processing it); Barby v. Cabot Corp., 465 F.2d 11, 15 (10th Cir. 1972) (the royalty owner tied his royalty payment to the market value of the natural gas at the wellhead and is precluded from contending that royalties are due on the end products after processing); James Petroleum Corp. v. Commissioner, 238 F.2d 678 (2d Cir. 1956) ("An oil royalty interest is only a right to share in oil and gas if and when produced. . . .") Phillips Petroleum Co. v. Record, 146 F.2d 485, 486 (5th Cir. 1944) (a right to receive one-

succinctly observed, a royalty "does not depend on the use the operation in fact makes of the gas produced, but upon the market value thereof." [6]

The district and appellate courts below both purported to accept this fundamental premise, then inconsistently approved a valuation methodology—netback (sometimes called workback)—which as applied in this case unlawfully captures the value added downstream by the lessee, Marathon. In transporting its natural gas production from the lease to its nearby LNG manufacturing plant, Marathon did not enter into a sale. On the other hand, comparable sales of the same gas from the same field and in substantial quantities did occur.[7] Notwithstanding the ready availability of this sound measure of value, DOI chose to use netback, a far more uncertain measure of value, which in this case yielded both unfair and unlawful results. Even those courts which have considered the use of the netback valuation technique have recognized its methodological shortcomings.[8] Indeed, some com-

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eighth of the gross proceeds does not entitle a royalty owner to receive one-eighth of the market value of the product manufactured from that gas); Phillips Petroleum Co. v. Ochsner, 146 F.2d 138, 141 (5th Cir. 1944) (the royalty owner is entitled to be paid on the basis of the market value of the natural gas at the well without regard to the use the lessee makes of the gas); Martin v. Glass, 571 F. Supp. 1406, 1412 (N.D. Tex. 1983) (royalty owner is entitled to receive the market price for his gas when processed and was not entitled to share in the increase received from the sale of processed products).

[6] 3 Williams, *Oil & Gas Law: Express Clauses of Oil and Gas Leases* § 634 (1982).

[7] A 1982 arms-length sales contract for gas from the same field, entered into with the Alaska Pipeline Company, reflects a value of $2.05 per Mcf, a value much lower than the approximately $3.00 per Mcf value yielded by DOI's netback calculation.

[8] Ashland Oil, Inc. v. Phillips Petroleum, 554 F.2d 381, 387 (10th Cir. 1975) ("It is obvious that comparable sales or current market price is the best [method of valuation], and second would come the

mentators have concluded that the netback method is even theoretically unsound since it erroneously equates costs of production to value added.[9]

Furthermore, the inherent deficiencies of the netback method are magnified in this case. In the *Ashland v. Phillips* cases [10], netback was employed in the absence of comparable sales by using a downstream contract price for crude helium to arrive at a value for helium entrained in the natural gas stream. In this case, the probability of error is magnified because DOI went further downstream in its netback calculation, starting with the contract price for LNG at dockside in Japan to ascertain a value for natural gas produced in Alaska.[11]

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work-back method"); Ashland Oil, Inc. v. Phillips Petroleum, 463 F. Supp. 619, 621 (N.D. Okla. 1978), *rev'd on other grounds*, 607 F.2d 335 (10th Cir. 1979) ("Market structures vary at different production stages and correlating figures from one stage to the next can require abstruse analytical calculations, easily resulting in error. If one fact has emerged clearly at retrial, it is the inappropriateness of using refined helium prices as a starting point in extrapolating commingled helium's value at the wellhead."); Northern Natural Gas Co. v. Grounds, Memorandum of Opinion, "The Workback Method", at 50 (D. Kan. Oct. 18, 1983) ("This remarkable spread of values between the separately operated Helex plants . . . occurs when the work-back method is blindly applied, solely upon a mathematical basis. . . .").

[9] *See*, R. Leftwich and S. Yu, *The Workback Method of Valuing Raw Materials: The Helium Cases*, Oil and Gas Tax Quarterly, December 1986, Volume xxxv, No. 2. ("[T]he workback method is virtually useless as a means of determining the value of a raw material. The rationale for its use was not grounded in sound economic theory. . . . [I]t uses accounting procedures and costing to measure value added at each of several processing stages—a task that accounting procedures are not designed to accomplish.")

[10] *Supra*, note 8.

[11] DOI would justify its use of netback here by reliance on the "gross proceeds" language of its regulations, asserting that the

Theoretical considerations aside, and without having to address the use of netback *per se*, it is clear that the application of netback in this case yielded patently unfair and unlawful results. Whereas comparable sales of the same raw natural gas from the same field and in substantial quantities yield a value of about $2.05 per MCF, DOI's netback methodology yields a value of about $3.00 per MCF [12]—a difference in value of fifty percent. That extra increment of value wrongly attributed to the wellhead value actually represents a portion of lessee Marathon's entreprenurial profits to which DOI is not entitled.

Where Congress has contemplated a government share in profits it has done so in explicit terms. For example, in the Outer Continental Shelf Lands Act Amendments of 1978, 43 U.S.C. § 1337(a)(1)(D)-(F)(1982), Congress permits the Department of the Interior to consider a variety of bidding systems, several of which include profit sharing arrangements between lessees and the government. Yet Congress has never prescribed any method other than a traditional percentage royalty for federal onshore oil and gas leases. Absent clear statutory author-

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landed sales price of LNG in Japan is the gross proceeds for natural gas produced in Alaska, *infra*, section III.

The fallacy of this conclusion stems from DOI's erroneous factual assumption that liquefied natural gas is equivalent to natural gas. Manufacturing LNG requires the removal of water, impurities, and heavier hydrocarbon fractions (particularly pentanes and heavier). Gas chromatographs will show that natural gas and LNG are distinctly and chemically different.

The district and appellate courts' failure to comprehend the marked differences between the natural gas produced and the LNG manufactured from it caused them to lose sight of a fundamental valuation principle: royalty is due on the value of production, not on the value of chemically distinct products manufactured downstream.

[12] The district court has retained jurisdiction to determine the manufacturing and transportation costs which Marathon may deduct in calculating royalties due under the netback method.

ity, DOI cannot confer upon itself the right to collect a net profits share on processed products, either directly or through blind application of a fundamentally flawed valuation methodology.

The Court is committed "to giv[ing] effect to the unambiguously expressed intent of Congress." *Chevron, U.S.A. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984) (footnote omitted). We submit that the Ninth Circuit mechanically applied standards of deference in this case without the threshold inquiry and finding that Congress' meaning was ambiguous in its use of the terms "royalty" and "production." Congressional clarity obviates any exercise in interpretation by an agency and judicial deference to such an interpretation is erroneous. *Id.* at 842-43. As such, the flawed decision of the Ninth Circuit requires consideration and correction by this Court.

II. The Ninth Circuit Decision Permits DOI Royalty Collection to Undercut Federal Policies Encouraging Domestic Energy Production

By basing royalty on an unlawfully expanded definition of production—which captures the value added by manufacturing—and by using a netback valuation technology, when other far more certain and legal measures of value are available, DOI unlawfully increased the producer's cost of production.[13] This increase in the producer's cost will only create disincentives for producers to engage in domestic exploration and production, an inherently high risk venture.[14] Such a result contravenes

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[13] This Court has recognized that escalated royalty costs adversely affect the producers' cost of production. See FERC v. Pennzoil Producing Co., 439 U.S. 508, 514 (1979) (FERC is empowered under the Natural Gas Act to grant "an individual producer a rate increase at variance with the established area or national rate in order to accommodate an increase in royalty costs").

[14] *See*, In Re Permian Basin Area Rate Cases, 390 U.S. 747, 756-57 (1968) ("Producers of natural gas cannot usefully be classed

the national policy goals embodied in the federal leasing statutes and Natural Gas Policy Act of 1978 (NGPA)[15] that seek to foster exploration for and development of our Nation's energy resources.

Indeed, this Court has recognized that the overriding goals of natural gas regulation are "assur[ing] an adequate and reliable supply of gas at reasonable prices" [16] and "encouraging the exploration for and development of new sources of natural gas." [17] The comprehensive federal regime of regulation of natural gas prices under the NGPA was intended to preserve and expand incentives for the production of intrastate and interstate gas. Thus, this Court observed that "[i]n each category of gas, the statute explicitly establishes an incentive pricing scheme. . . . The new statutory rates are intended to provide investors with adequate incentives to develop new sources of supply." [18]

With respect to the Mineral Lands Leasing Act, the Court of Appeals for the Tenth Circuit understood that

> [t]he purpose of the [] Act was to promote the orderly development of the oil and gas deposits in the publicly owned lands of the United States through private enterprise.[19]

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as public utilities. They enjoy no franchises or guaranteed areas of service. They are intensely competitive vendors of a wasting commodity they have acquired only by costly and often unrewarded search.")

[15] 15 U.S.C. §§ 3301 et seq. (1982).

[16] California v. Southland Royalty Co., 436 U.S. 519, 523 (1978); *see also* Atlantic Refining Co. v. Public Service Commission, 360 U.S. 378, 388-89 (1959).

[17] FPC v. Texaco, Inc., 417 U.S. 380, 388 (1974).

[18] Public Service Commission v. Mid-Louisiana Gas Co., 463 U.S. 319, 333, 334 (1983).

[19] Harvey v. Udall, 384 F.2d 883, 885 (10th Cir. 1967) (quoting Senate Subcommittee on the Committee on Interior and Insular Affairs, The Investigation of Oil and Gas Lease Practices, 84th Cong., 2d Sess. 2 (1957)).

In utilizing the netback for product valuation, DOI is undermining congressionally enacted policies which "promote . . . development . . . through . . . enterprise." In twisting the understood meaning of the statute's words "production" and "royalty", DOI has unilaterally elevated maximization of royalty revenues as the dominant goal of the Act. In so doing, it has substantially increased producers' costs of production, thereby discouraging, rather than promoting, their enterprise.

In the Outer Continental Shelf Lands Act, Congress also expressed as a goal for the nation the development of domestic energy resources. In fact, in amending the Act in 1978 Congress declared that the purpose of the Act is, *inter alia*,

> to establish policies and procedures for managing the oil and natural gas resources of the Outer Continental Shelf which are intended to result in *expedited exploration and development of the Outer Continental Shelf* in order to achieve national economic and energy policy goals, assure national security, reduce dependence on foreign sources, and maintain a favorable balance of payments in world trade. (emphasis supplied).[20]

DOI's royalty collection policy as exercised in this case is at odds with congressionally-mandated federal policies which encourage the expeditious development of our na-

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[20] 43 U.S.C. § 1802(1) (1982). Congress also expressly found, *inter alia*:

> (1) the demand for energy in the United States is increasing and will continue to increase for the foreseeable future;
>
> (2) domestic production of oil and gas has declined in recent years;
>
> (3) the United States has become increasingly dependent upon imports of oil from foreign nations to meet domestic energy demand;
>
> (4) increasing reliance on imported oil is not inevitable but is rather subject to significanct reduction by increasing the development of domestic sources of energy supply. 43 U.S.C. § 1801(1)-(4).

tion's energy resources. It need not be. If DOI properly bases royalty determination on the value of production, its royalty collection program would satisfy all of the federal policies underlying the minerals leasing laws, including collection of reasonable royalties. Reversal of the decision below will restore the proper balance which accommodates all federal policies.

III. Resolution of This Issue Now Is Timely

The Department of the Interior and the courts below have relied heavily on the "gross proceeds" clause in the current valuation regulations to justify their conclusions.[21] Specifically, the district court concurred in DOI's determination that "the net back method was *necessary* to satisfy the gross proceeds requirement." [22] (emphasis supplied). The Ninth Circuit, when it addressed the substantive issue in this case, did not revisit this issue but

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[21] 30 C.F.R. § 206.103 (1986) provides:

> § 206.103 Value basis for computing royalties. The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the Associate Director due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any said substance for the purposes of computing royalty be deemed to be less than the *gross proceeds* accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price per barrel, thousand cubic feet, or gallon paid or offered at the time of production in a fair and open market for the major portion of a like-quality oil, gas, or other products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value. (emphasis supplied).

[22] Marathon Oil Co. v. United States, 604 F. Supp. 1375, 1385 (D. Alaska 1985), *aff'd*, 807 F.2d 759 (9th Cir. 1986).

merely incorporated by reference "the reasons so ably discussed by the district judge in discussing the issues before him. . . ." [32] But use of the netback method in this case was neither necessary nor lawful.

This pivotal "gross proceeds" regulation has existed since at least 1936,[24] but in 1987, the district court's own finding is still true: "The phrase 'gross proceeds' is not defined in the regulations." [25] Application of this regulation, then, necessitates resolution of the point at which "gross proceeds" are calculated to determine the percentage royalty. Marathon correctly asserted, by reference to the Minerals Lands Leasing Act, that the point for measurement of gross proceeds is at the wellhead, whereas DOI marks the point at dockside in Japan. Most unfortunately, the courts below and DOI have ascribed independent significance to the regulation, ignoring the statutory limitation that the federal royalty be based on "the value of production", to the exclusion of value added downstream.[26]

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[23] Marathon Oil Co. v. United States, 807 F.2d 759, 766 (9th Cir. 1986).

[24] Section 3(e) of the Oil and Gas Operating Regulations, 12/1/36. *See,* United States v. Ohio Oil, 163 F.2d 633, 639 (10th Cir. 1947).

[25] *Marathon,* 604 F. Supp. at 1384.

[26] The district court focused exclusively on the intrinsic context of the regulation itself, losing sight of the delimiting statutory basis from which the regulation flows:

> I agree that the first sentence of the regulation directs the Associate Director to look to sales price in the field. However, the regulation does not end there. In the second sentence, it requires that the royalty basis be not less than the gross proceeds accruing to the lessee. *Id.* at 1384.

The district court discerned a conflict between the first and second sentences where none existed, i.e., the "gross proceeds accruing to the lessee" are those obtained from "sales . . . in the field." *Marathon,* 604 F. Supp. at 1384.

The court reasoned that a " 'proceeds' type royalty clause" will be computed on the basis of aggregate gross receipts from all

This Court's review of the case would be especially timely given the pendency of important and long-awaited product valuation rulemaking by the DOI's Minerals Management Service.[27, 28]

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products less costs of marketing and transportation. *Id.* at 1384 (citing R. Hemingway, *The Law of Oil and Gas* § 7.4, at 351 (2d ed. 1983)). The case of United States v. Wichita Industries, 390 F. Supp. 1154 (W.D. Okla. 1974) contradicts this conclusion, however, through reference to an Indian lease executed as far back as 1920. The lease provided:

> The lessee hereby agrees to pay . . . the lessor, as royalty, the sum of twelve and one-half percent of the *gross proceeds* of all oil *extracted*. . . . (emphasis supplied). *Id.* at 1155.

The lease provision clearly refers to gross proceeds from sale of production in the field, i.e., *"extracted." See also*: Ashland Oil & Refining Co. v. Staats, 271 F. Supp. 571, 578 (D. Kan. 1967). ("[R]oyalty is not payable on the gathering and transportation charges. We hold, further, that such charges are not "proceeds" from the sale of gas, upon which royalties are payable.")

[27] On February 15, 1986 (51 Fed.Reg. 4507) the Minerals Management Service published an advance notice of proposed rulemaking. On January 15, 1987 (52 Fed.Reg. 1858) the MMS published a notice of proposed rulemaking for valuation of oil. On February 13, 1987 (52 Fed.Reg. 4732) the MMS published a notice of proposed rulemaking for the valuation of natural gas. These rulemakings, expected to be completed in late 1987, are a direct result of the Linowes Commission which, in its report, urged DOI to clarify its product valuation regulations. Commission on Fiscal Accountability of the Nation's Energy Resources (Washington, D.C., January 1982), (the "Linowes Commission").

[28] In its notice of proposed rulemaking, DOI has adopted a prioritized benchmark system for the valuation of products for royalty purposes. In the first instance, DOI will use contract proceeds from arm's-length contracts to determine value. Absent arm's-length contracts, comparable contracts, then other measures of value (e.g., spot prices) are used. Use of the netback method is, however, relegated to the last resort for gas valuation: "If a value cannot be determined using any of the valuation procedures previously mentioned, a net-back procedure to value the gas could be used." 52 Fed.Reg. at 4736 (Feb. 13, 1987); *See also* 52 Fed.Reg. at 1861-2 (Jan. 15, 1987) (proposed oil valuation regulations).

A central issue in the rulemaking is the very definition of gross proceeds and its application. Supreme Court review of this case would, at this important juncture, clarify this central issue of federal oil and gas law.

Federal lessees have never agreed to share with the federal government a portion of downstream entrepreneurial value. The dubious application of the netback valuation method, coupled with DOI's own *post facto* reservations in the pending rulemaking, warrant this Court's plenary review.

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

Of Counsel
THOMAS L. CUBBAGE II
1256 Adams Building
Bartlesville, OK 74004

G. WILLIAM FRICK
(Counsel of Record)
DAVID T. DEAL
PHILIP A. COONEY
AMERICAN PETROLEUM INSTITUTE
1220 L Street, N.W.
Washington, D.C. 20005
(202) 682-8246
Counsel for Amicus Curiae

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